

January 22, 2020

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities (Docket No. R-1673 and RIN 7100-AF 56)

Dear Ms. Misback:

We are pleased to offer these comments on the Board's above-referenced proposed rulemaking. Our comments are limited to the Building Block Approach described in the proposal (the **BBA proposal**).

Founded in 1857, The Northwestern Mutual Life Insurance Company is one of the largest life insurers in the United States, with \$1.8 trillion of life insurance protection in force for 3.9 million policy owners and total assets of \$272 billion. Northwestern Mutual and its subsidiaries also offer annuities, disability income insurance, and long-term care insurance, as well as wealth management services (\$128 billion in client investment assets under management). As a mutual, the company is owned by its policy owners who share in any earnings and surplus that is not retained by the company for the purpose of ensuring solvency and financial strength.

While Northwestern Mutual is not a depository institution holding company and so not subject to the proposed rule, the company holds a strong interest in regulatory developments that concern measurement of risk and capital strength. Northwestern Mutual has consistently maintained the highest available financial strength ratings for a US insurance company throughout its modern history, and treats the identification, assessment, and management of solvency regulatory developments as an important component of enterprise risk management.

We recognize that a thoughtfully-constructed group capital measure can serve as a useful supervisory tool to complement existing entity-focused measures of capital strength, particularly for firms with more complex business operations (including international insurance business) and organizational structures. On the other hand, a group capital measure may also be constructed in a way that presents a distorted view of an insurance group's financial strength, presenting regulators with false positives and/or false negatives and damaging the insurer's ability to offer secure and valuable products to its policyholders. This is particularly so with long-duration life insurance products, given the sensitivity to assumptions over time. From this perspective, the aggregation-based BBA proposal presents a welcome alternative to the market-adjusted valuation reference Insurance Capital Standard being developed by the IAIS (the **MAV ICS**).

The following themes represent our high-level response to the proposed rule:

1. We support the Board's construction of the BBA proposal, consistent with our comments to the Advance Notice of Proposed Rulemaking the Board issued in 2016. We describe the strengths to

a well-constructed aggregation approach to a group capital measure, such as outlined in the BBA proposal, in our response to Question 1.

2. Constructing an effective aggregation approach such as the BBA proposal is particularly important in light of the development of the MAV ICS, with its volatile and pro-cyclical valuation methodology which would, based on our assessments, produce potentially false impressions of financial strength or weakness for long-duration life insurance products such as those that have benefited our policyholders for many decades. The experience in Europe since the adoption of a similar regime, Solvency II, indicates that imposition of such a capital measure is likely to diminish the availability of long-duration life insurance products. Such an outcome in the United States, where public retirement income programs may be less robust, would be highly undesirable for consumers and society.
3. We also commend the Board for incorporating within the BBA proposal the features necessary to overcome some of the potential pitfalls or weaknesses that could arise if not carefully addressed within an aggregation approach to calculating a group capital figure:
 - Starting from a comprehensive inventory of affiliated companies within the group to avoid gaps (particularly important as the complexity of some insurance groups increases);
 - Thoughtfully constructing scalars so that different valuation and capital regimes can be aggregated in a meaningful way;
 - Incorporating adjustments where material inconsistencies exist within the US state insurance valuation and capital regime, including by reversing permitted/prescribed practices and restating captives to NAIC valuation and RBC; and
 - Including consolidation mechanisms to address the potential for double-counting.
4. With the BBA proposal fundamentally satisfying these big picture concepts, our recommendations for changes are limited to a modest number of specific implementation issues. Those items we believe are most important to address in order for the BBA to be successfully implemented are:
 - Allow practical approximations for application of PBR to in-force term and ULSG business. This would serve the Board's objective of providing a truer measure of risk exposures for in-force business, applied consistently regardless of captive use, while at the same time avoiding unnecessarily burdensome calculations.
 - Clarify that surplus notes satisfying customary state insurance regulatory requirements, including NAIC statutory accounting provisions, will not disqualify them from recognition as qualifying capital instruments, recognizing that these provisions do not detract from the loss-absorbency of surplus notes, particularly given the conservative boundaries that the Board's proposal would impose on Tier 2 qualifying capital.
 - Recognize the excess conservatism in the capital requirement and conservation buffer, and consider a mechanism for the calibration to change as NAIC valuation and RBC change.
 - Clarify treatment of investment management subsidiaries so that the BBA provides a consistent treatment of these type of entities (regardless of where they reside within the organizational structure).

- Work with NAIC to bridge from the thoughtful “probability of default” scalar methodology in the BBA to a practical approach for scaling across insurance jurisdictions internationally.

On the pages below, please find our responses to a select portion of the questions presented within the proposed rule, consistent with the foregoing themes.

We thank you again for the opportunity to comment.

Respectfully submitted,



Michael G. Carter
Executive Vice President, Chief Financial Officer
and Chief Risk Officer
mikecarter@northwesternmutual.com



Raymond J. Manista
Executive Vice President, Chief Legal Officer,
Chief Compliance Officer and Secretary
raymanista@northwesternmutual.com

Question 1: The LAIS is currently considering a MAV approach for the ICS; in contrast, the BBA aggregates existing company-level capital requirements throughout an organization to assess capital adequacy at various levels of the organization, including at the enterprise level. What are the comparative strengths and weaknesses of the proposed approaches? How might an aggregation-based approach better reflect the risks and economics of the insurance business in the U.S.?

The comparative strengths of a well-constructed aggregation method, such as that outlined in the BBA proposal, include the following:

- Being built up from entity figures provides insight into how the entities that make up the group contribute to or detract from the group's overall financial strength;
- This includes greater insight over time into trends that may be developing at the legal entity level;
- Aggregation from legal entities allows greater potential to reflect limitations on fungibility of capital across legal entities (and so give a truer picture of the actual potential for entities to be a source of strength for other parts of the group);
- Construction from jurisdictional regulatory valuation and capital may better reflect the attributes of the risk applicable to the entities (and ultimately the group), as those jurisdictional regimes have developed over time to reflect the idiosyncratic attributes of each jurisdiction (and appropriately distinguish insurance from banking); and,
- Ultimately, by avoiding a requirement that insurance entities restate valuation and capital by using an inconsistent regime, the BBA not only is more efficient for companies and regulators but also avoids the potential for negative consequences resulting from a different approach.

In contrast, the MAV ICS, with its volatile and pro-cyclical valuation methodology would, based on our assessments, produce potentially false impressions of financial strength or weakness for long-duration life insurance products such as those that have benefited our policyholders for many decades. Such information would likely not be helpful for regulators. Moreover, the experience in Europe since the adoption of a similar regime, Solvency II, indicates that imposition of such a capital measure is likely to diminish the availability of long-duration life insurance products. Such an outcome in the United States, where public retirement income programs may be less robust, would be highly undesirable for consumers and society.

We would also challenge one of the premises underlying the MAV ICS – that applying a uniform methodology to insurance assets and liabilities regardless of jurisdiction is necessary or beneficial to avoid international regulatory arbitrage. While capital may move globally, insurance markets are fundamentally national in nature, with insurers competing with one another on the basis of local rules to satisfy local market demands. Insurance products and the regulatory regimes to which they are subject have developed in tandem to reflect unique national attributes, such as societal/cultural norms, systems of taxation, the balance of public vs. private participation in markets, etc. From this perspective, establishing an insurance group capital calculation on the basis of a single global-level standard may be neither helpful nor desirable.

We also recognize that an aggregation approach does present some potential challenges that do not arise in a top-down consolidated approach such as the MAV ICS. We commend the Board for incorporating the following features necessary to overcome some of the potential pitfalls or weaknesses that could arise if not carefully addressed within an aggregated approach to calculating a group capital figure:

- Starting from a comprehensive inventory of affiliated companies within the group to avoid gaps (particularly important as the complexity of some insurance groups increases);
- Thoughtfully constructing scalars so that different valuation and capital regimes can be aggregated in a meaningful way;
- Incorporating adjustments where material inconsistencies exist within the US state insurance valuation and capital regime, including by reversing permitted/prescribed practices and restating captives to NAIC valuation and RBC; and
- Including consolidation mechanisms to address the potential for double-counting.

Question 2: In what ways would an aggregation-based approach be a viable alternative to the ICS? What criteria should be used to assess comparability to determine whether an aggregation-based approach is outcome-equivalent to the ICS?

We believe a well-constructed aggregation approach such as that proposed by the Board in the BBA proposal is not only a viable alternative but will be superior to the MAV ICS.

Notably, an aggregation approach is compatible with regimes that use a consolidated market-adjusted valuation methodology. Such regimes (e.g., Europe's Solvency II) can be scaled with other risk-based insurance capital regimes (e.g., NAIC RBC). So, in contrast to the destructive results that would occur if the MAV ICS is applied to the US and other markets with significant long-duration insurance business, the application of an aggregation approach globally would respect and helpfully integrate with market-adjusted regimes such as Solvency II.

In terms of comparability assessments, we suggest that the first fundamental step is to agree that the objective is to recognize those international group capital methodologies that serve the purpose of aiding supervisors of internationally active groups in doing their work. It follows then that the assessment should be on the basis of common criteria against which both the MAV ICS and the aggregation method should be judged. It would not serve the ultimate objective of facilitating and improving the work of supervisors to presume that the MAV ICS is the basis against which alternatives should be judged.

In setting those common criteria, it will also be important to recognize that no group capital measure can be a substitute for rigorous examination of all potentially material sources of financial strength or weakness within the group, including non-insurance entities that exist outside of capital and regulatory requirements (e.g., use of derivatives in an unregulated subsidiary within the group). A core purpose of a group capital measure is to support such analysis.

Question 13: The Board invites comment on the proposed approach to determine applicable capital frameworks. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?

We are fundamentally supportive of the Board's approach to determining applicable capital frameworks. Its chief advantage is that it recognizes the importance of distinguishing between the insurance and banking businesses and their respective valuation and capital regimes. We also support the Board's recognition that captive reinsurance entities should be restated to NAIC statutory valuation and RBC.

We do see a potential gap or discrepancy in the treatment of asset management businesses. Depending on an insurance group's organizational structure, an asset management business may or may not be a subsidiary of an insurance company. We read the exclusion of asset management businesses from the definition of "material financial entity" to mean that in some cases an asset management business that is a subsidiary of an insurer will be treated according to NAIC RBC within the parent insurer's building block, whereas an asset management business located elsewhere within the corporate structure may receive a different treatment. We do not understand what regulatory purpose would justify the difference in treatment.

Question 14: What other definitions of materiality, if any, should the Board consider for use in the BBA? Examples may include a threshold based on size, off-balance sheet exposure, or activities including derivatives or securitizations.

We interpret the intention of the Board's proposed definition of materiality as to identify those entities within the group, not otherwise subject to or adequately addressed by one of the regulatory capital frameworks upon which the BBA is constructed (i.e., NAIC RBC or Federal banking capital rules), that are sufficiently material such that they require special attention in order for the BBA ratio to provide a meaningful measure of group-level capital strength of the top-tier depository institution holding company.

In general, we believe the proposed definition of materiality should do a reasonable job of serving this purpose. That said, we caution that there is a potential for ambiguity or circularity when it comes to the use of this definition and the concept of "total exposure". For example, with captive reinsurers, presumably the intention would be for the "total exposure" to a captive reinsurer to be measured by assessing the absolute value of "company capital elements" or the value of an implicit or explicit guarantee on a basis consistent with NAIC SAP and RBC. Yet, if it is only those captive reinsurers that are "material financial entities" that are required to apply NAIC SAP and RBC (see page 57253, section IV.C.3.(a), of the NPR), this begs the question as to how such entities and potentially material sources of risk to the group will satisfactorily be identified. The Board could address this by requiring that the assessments of "total exposure" to a captive reinsurer be calculated in accordance with NAIC SAP and RBC.

Question 16: The Board invites comment on the use of the material financial entity concept. What are the advantages and disadvantages to the approach? What burden, if any, is associated with the proposed approach?

The use of a material financial entity concept appears to be a reasonable way to establish a clear threshold for identifying a financial entity that requires special attention under an aggregation method because the entity is not already subject to or adequately addressed by one of the regulatory capital frameworks upon which the BBA is constructed (i.e., NAIC RBC or Federal banking capital rules). But, please see our response to Question 13 above as it relates to a potential discrepancy in the treatment of asset management subsidiaries (which are generally excluded from the definition of material financial entity) based upon organizational geography.

Question 18: What risk-sensitive approaches could be used to address the risks presented by asset managers in an insurance depository institution holding company's enterprise?

For asset managers that are subsidiaries of insurers, the existing NAIC RBC approach of applying a flat charge against book adjusted carrying value was developed to be sensitive to the risk presented to a parent insurer's surplus position by a loss in value of its equity investment in the non-insurance subsidiary. A Basel III-style charge against a measure of revenue would be more sensitive to risks that arise from the volume of business occurring within the entity. Each is risk-sensitive, but to a different set of risks.

Question 19: What forms or structures, if any, do asset managers or their holding companies take in insurance enterprises, such that they may fall within the proposed definition of an MFE?

Insurance groups may maintain asset management businesses as an insurance company subsidiary or elsewhere within the holding company structure. As we read the MFE definition, such entities would in some cases be excluded. As noted in our response to Question 13, above, we do not understand what regulatory purpose would be served by the resulting discrepancy in treatment based on organizational structure.

Question 22: The Board invites comment on the proposed approach to scalars and the associated white paper. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?

In general, the "probability of default" methodology developed by the Board to scale between US Federal banking and NAIC RBC seems well-grounded and sensible. The primary limitation of the "probability of default" methodology is its dependence on data establishing relationships between capitalization relative to the regulatory intervention point and probability of default. Given that such data may be less readily available for non-US insurance jurisdictions, it is important to develop practical alternatives where such scalars are needed, such as with the NAIC's GCC.

Question 23: How should the Board develop scalars for international insurance capital frameworks if needed?

We observe that the "provisional scalar" methodology set forth in the BBA proposal is a relatively crude approach in comparison with the two methodologies that the NAIC has field tested for their GCC (the relative ratio approach and excess capital ratio approach). We submit

that in the absence of the default data necessary to apply a probability of default approach in the international context, the NAIC's efforts based on establishing relationships between regulatory intervention points and average industry capitalization are a reasonable start. We encourage the Board to continue to work together with the NAIC to develop credible scaling methodologies for non-US insurance jurisdictions.

Question 24: The Board invites comments on all aspects of the proposed adjustments to capital requirements. Should any of the adjustments be applied differently? What other adjustments should the Board consider?

IV.C.3.(a) indicates that for "...certain insurance companies that exist to reinsure risk from affiliates... such companies' financial information should be restated in accordance with SAP", which includes "...the use of Principle-Based Reserving (PBR) on business that is currently grandfathered." (footnote 53) Furthermore, "Such companies as restated should be subjected to capital treatment under RBC...."

We agree that such adjustments are important to establish a meaningful and credible aggregation method of group capital. The adjusted reserves provide a truer measure of liabilities for in-force business, and using those adjusted reserves in RBC calculations would appropriately reflect the risk of the in-force business. To support the desired consistency between reporting entities, we anticipate these adjustments would be made for all grandfathered business, whether affiliate reinsurers exist or not.

However, establishing full-blown PBR calculations for all grandfathered business could be very complex and costly. We recommend allowing practical approximations for the application of PBR to in-force term and ULSG business. This would serve the Board's objective of providing a truer measure of risk exposures for in-force business, applied consistently regardless of affiliate reinsurer use, while at the same time avoiding unnecessarily burdensome calculations. The approximations used by the NAIC in its 2019 Group Capital Calculation field testing could provide guidance for this approach. For instance, applying a factor such as 40% to grandfathered term insurance reserves would be simple and consistent across reporting entities, while reasonably approximating an appropriately conservative level of principle-based reserves.

We have an additional suggestion for clarification regarding adjustments for grandfathered measures. The NAIC's XXX/AXXX Reinsurance Framework, which was the NAIC's resolution to the issue of life insurer use of captive reinsurance for term and ULSG reserve financing transactions, included provisions for grandfathering business subject to transactions as of a specified date. One of the key provisions of the XXX/AXXX Reinsurance Framework is a requirement that in a term or ULSG captive reinsurance transaction, a "PBR level" of reserves must be backed by assets meeting a "Primary Security" standard. The Primary Security standard goes beyond general SAP admissibility, for example excluding bespoke contingent assets and affiliated investments regardless of whether they are viewed to meet SAP admissibility rules. While we recognize that there are valid regulatory reasons for maintaining grandfathering decisions at the legal entity level, for purposes of establishing an approach within the BBA that can be consistently applied and is consistent with a single NAIC standard, we recommend that

the Board incorporate adjustments consistent with the XXX/AXXX Reinsurance Framework, including asset adjustments consistent with a Primary Security standard.

Question 25: The Board invites comments on all aspects of the proposed adjustments to available capital. Should any of the adjustments be applied differently? What other adjustments should the Board consider?

We refer to our answer to Question 24, above, as the same considerations we identified there for adjustments to required capital should likewise apply to available capital.

Question 26: What other criteria, if any, should the Board consider for determining available capital under the BBA?

Please see our responses to questions 27 through 31 related to refinements needed to the qualifying capital criteria for surplus notes.

Question 27: One of the criteria, concerning capital instruments that contain certain call features, requires the top-tier depository institution holding company to obtain prior Board approval before exercising the call option. Should the Board apply a de minimis threshold below which this approval is not needed?

We do not have a strong view on the question of applying a *de minimis* threshold for requiring Board approval upon the exercise of a call option. However, as a mutual company, for which the only non-organic way to raise capital is through surplus notes, we do have significant concerns if the qualifying capital criteria within the BBA proposal hinder access to loss-absorbing capital from surplus notes, assuming those notes are issued in accordance with terms customarily required by state insurance regulators.

One such discrepancy with customary terms we have identified is the limitation on call provisions (prohibiting call provisions exercisable within the first five years following issuance with limited exceptions). Most surplus notes have a call option to maintain future flexibility (e.g., a call option may provide flexibility to the issuing insurer in the event of a substantial change in circumstances, such as an acquisition or some other reorganization). Most call options are somewhat punitive (e.g., subject to a costly make-whole calculation) which makes it unlikely the surplus notes will be called. The market's recognition of this unlikelihood, and of the generally conservative operation of most mutual insurance companies, supports favorable rates on capital. As regulatory approval is needed to exercise such a call (that of both the insurer's domiciliary regulator and, under the BBA proposal, the Board) there is no risk that such surplus notes will be called in times of capital need. Consequently, the establishment of such criteria may work against the objective of promoting sound financial institutions by reducing the flexibility of insurers to raise long-term capital. We see no regulatory benefit to imposing different and potentially conflicting criteria from those stipulated in customary state insurance rules for surplus notes.

As a general matter, absent the articulation of a compelling regulatory concern, we believe the Board's qualifying capital criteria related to surplus notes should be limited to state law, including requirements of NAIC SAP, with the exception of the Board's regulatory approval

required for redemption (call or otherwise) for insurance companies subject to the BBA. As a practical matter, any state variations in this context are not likely to meaningfully impact the Board's supervisory objectives, given strict SAP criteria for meeting the requirements of surplus note accounting (impacting classification as surplus vs. debt) and the mechanisms the BBA proposal includes for reversing the effects of permitted and prescribed practices.

Question 29: What grandfathering date should the Board use?

It may be unrealistic and impractical for companies to anticipate whether they may in the future become subject to Board regulation and adjust their surplus notes issuances accordingly prior to becoming subject to such regulation. As such, we recommend that grandfathering be as of the date an insurance group becomes subject to Board regulation.

We do not anticipate that the flexible grandfathering approach we suggest would interfere with the Board's regulatory objectives given the loss-absorbing attributes of surplus notes issued in accordance with customary state insurance regulatory requirements. As noted in our response to Question 27 above, we see no need for the BBA criteria for surplus notes to differ from those required under state law, including NAIC SAP, and believe differing criteria would actually be detrimental.

Question 30: What alternate formulations of the limit on tier 2 capital may be more appropriate, while still ensuring appropriate quality of capital?

We limit comments to this question to surplus notes, which have proven to be high quality, durable and loss-absorbing capital. One of the requirements for surplus notes to be recognized as capital under NAIC SAP is that the proceeds received from the issuance of surplus notes be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile. Further, surplus notes must have the following provisions:

- Subordination to policyholders;
- Subordination to claimant and beneficiary claims;
- Subordination to all other classes of creditors other than surplus note holders; and
- Interest payments and principal payments require prior approval of the commissioner of the state of domicile.

Most surplus notes have maturities of 20, 30, 40 or even 50 years. They generally can be replaced prior to or upon maturity unless the insurer is in difficult financial condition. However, in that case, the state insurance regulator may be expected to exercise their discretion not to approve payment of principal and interest, ensuring the ongoing loss-absorbing capacity of the notes. We therefore do not see a need for an alternative formulation of the limit for surplus notes as tier 2 capital (please also see our response to Question 31).

Question 31: Aside from a limit on tier 2 capital instruments, are there other ways to ensure sufficiently loss absorbing available capital and/or prevent an institution from relying disproportionately on capital resources that are less loss absorbing?

As related to surplus notes, while we do not propose an alternative formulation, we also do not believe any further limits are required to ensure sufficient loss absorbing available capital and/or to prevent an institution from relying disproportionately on capital resources that are less loss absorbing. For the reasons described in our response to Question 30 above, we believe the loss absorbing quality of surplus notes is near, if not equal, to that of other forms of capital.

In practice, surplus notes on average contribute only a modest portion of capital to the life insurers that have issued them. For 2018, surplus notes constituted 11.0% of surplus and AVR, calculated on a weighted average basis across such companies. The average surplus ratio for such companies (calculated, on a weighted average basis, as $[\text{surplus} + \text{AVR}] / [\text{reserves for life contracts} + \text{reserves for A\&H} + \text{liability for deposit type contracts}]$) was 12.5% including notes, and 11.2% excluding notes from the numerator.

In any event, by in effect limiting the amount of surplus notes that “count” towards the BBA capital requirement to 62.5% of ACL RBC (assuming the business is dominated by a mutual insurer as the top-tier parent) and by not counting any amount of surplus notes for the BBA’s capital conservation buffer, the Board has already proposed a treatment that layers substantial conservatism over the top of state insurance regulatory requirements.

Question 32: The Board invites comment on the proposed minimum capital requirement. What are the advantages and disadvantages of the approach? What is the burden associated with the proposed approach?

Our firm has long been supportive of appropriately conservative valuation and capital requirements for insurance businesses, given their importance in supporting our industry’s commitment to fulfilling long-term obligations to our policyholders. That said, we must observe that the Board’s BBA proposal embeds a substantial layer of conservatism above the 160% ACL figure that results from a strict application of the Board’s scalar from its banking requirements.

We understand that this margin is proposed to address the potential for variation from the results of the Board’s “probability of default” scalar. Whatever the likelihood of such variation, we submit that as a matter of good construction of an aggregation-based group capital methodology, the Board should endeavor to provide maximum transparency into the degree of conservatism it is embedding in its BBA capital requirement and capital buffer. This would allow the Board, over time, if appropriate, to reduce the excess of conservatism it is applying to insurance depository institution holding companies relative to other depository institution holding companies.

Likewise, we believe that the BBA proposal should incorporate a mechanism for future adjustments in the event of substantial changes to the NAIC’s statutory valuation and RBC rules.

Question 33: The Board invites comment on the proposed minimum capital buffer. What are the advantages and disadvantages of the buffer? What is the burden associated with the buffer?

Please see our response to Question 32.